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In the Supreme Court of the United States

OCTOBER TERM, 1984

TRANSCONTINENTAL GAS PIPE LINE CORPORATION,
APPELLANT

v.

STATE OIL AND GAS BOARD OF MISSISSIPPI AND
COASTAL EXPLORATION, INC., ET AL.

ON APPEAL FROM THE SUPREME COURT OF MISSISSIPPI

BRIEF FOR THE UNITED STATES AND THE FEDERAL ENERGY REGULATORY COMMISSION AS AMICI CURIAE SUPPORTING REVERSAL

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QUESTION PRESENTED

Whether the ruling of the Mississippi Supreme Court that an interstate pipeline is required to purchase gas at a uniform percentage (*i.e.*, ratably) from all owners in a common pool of gas, even when the inevitable consequence of the state regulation will be to increase rates charged ultimate consumers of gas in other states, constitutes state regulation forbidden under the Supremacy and Commerce Clauses of the United States Constitution.

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BRIEF FOR THE UNITED STATES AND THE FEDERAL ENERGY REGULATORY COMMISSION AS AMICI CURIAE SUPPORTING REVERSAL

INTEREST OF THE UNITED STATES AND THE FEDERAL ENERGY REGULATORY COMMISSION

Congress has charged the Commission [1] with the responsibility for administering and enforcing the Natural Gas Act, 15 U.S.C. 117 *et seq.*, and the Natural Gas Policy Act of 1978 (NGPA), 15 U.S.C. 3301 *et*

[1] The term "Commission" herein refers to the Federal Power Commission prior to October 1, 1977, and to the Federal Energy Regulatory Commission thereafter. See 42 U.S.C. 7172(a), 7295.

seq. See Section 402(a)(1)(C) of the Department of Energy Organization Act, 42 U.S.C. 7172(a)(1)(C); Sections 20-22 of the Natural Gas Act, 15 U.S.C. 717s-717u; and Sections 501(a), 504(b)(1) of the NGPA, 15 U.S.C. 3411(a), 3414(b)(1).

Under the Natural Gas Act, the Commission is responsible for establishing the resale rates for natural gas in interstate commerce at "just and reasonable" levels. Sections 4, 5 of the Natural Gas Act, 15 U.S.C. 717c, 717d. Under the NGPA, the Commission is responsible, inter alia, for enforcing the prices for wellhead sales of natural gas established by Congress under Title I of the NGPA, 15 U.S.C. 3311 *et seq.* See Section 504 of the NGPA, 15 U.S.C. 3414. It is also authorized to assure that the passthrough of gas costs by interstate pipelines to their customers is in accord with those prices and is not excessive due to "fraud, abuse, or similar grounds." Section 601(c)(2) of the NGPA, 15 U.S.C. 3431(c)(2). In all cases, the Commission must assure that the public has an adequate supply of natural gas in the interstate market "at the lowest possible reasonable rate consistent with the maintenance of adequate service in the public interest." *Atlantic Refining Co.* v. *Public Service Commission*, 360 U.S. 378, 388 (1959).

The Mississippi ratable-take rule at issue here significantly interferes with this comprehensive federal scheme of regulation; unless overturned, the rule is likely to raise the price of gas in the interstate market.

STATEMENT

Appellant, Transcontinental Gas Pipeline Corporation (Transco), is an interstate pipeline engaged in the purchase, transmission, and sale for resale of natural gas in interstate commerce, subject to the Nat-

ural Gas Act, 15 U.S.C. 717 *et seq.*, and the NGPA, 15 U.S.C. 3301 *et seq.* In this case Transco challenges, on preemption and Commerce Clause grounds, the order of the Mississippi courts, requiring Transco to purchase gas "ratably" from all interest owners in a common pool of gas—*i.e.*, to purchase from each interest owner the same percentage of allowable production from the pool as it purchases from every other interest owner.

A. The Statutory And Regulatory Background

The Natural Gas Act, 15 U.S.C. 717 *et seq.*, was adopted in 1938 "to occupy the field of wholesale sales of natural gas in interstate commerce," an area which this Court had held the states were barred from regulating under the Commerce Clause. *Exxon Corp.* v. *Eagerton*, 462 U.S. 176, 184 (1983).

The NGPA extended the scope of Congress's exercise of its authority over the sale of natural gas by adopting, in Title I, a "comprehensive" and "exhaustive" structure of tiered prices for all sales at the wellhead (*i.e.*, "first sales"), whether made in interstate or intrastate commerce. *Public Service Commission* v. *Mid-Louisiana Gas Co.*, 463 U.S. 319, 332 (1983). Insofar as relevant here, Congress in Title I deregulated the price of certain categories of gas [2] and assigned other categories specified "incentive"

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[2] The gas at issue here is deregulated "high-cost" gas. Section 107(c)(1) of the NGPA, 15 U.S.C. 3317(c)(1), defines "high-cost natural gas" as gas produced from wells begun on or after February 19, 1977, at completion locations deeper than 15,000 feet. Under Section 121(b) of the NGPA, 15 U.S.C. 3331(b), the "first sale" (*i.e.*, field or wellhead) price of such gas is not subject to price controls. Other gas, qualifying under NGPA Sections 102(c), 103(c), 105 and

ceiling prices in order to stimulate production.[3] At the same time, Title I extended Natural Gas price controls (with an inflation adjustment factor) to particular categories of gas, especially old dedicated gas.[4] The overall objective was "to encourage natural gas production while providing consumers with a smooth transition to natural gas decontrol." [5]

Section 601 of the NGPA, 15 U.S.C. 3431, entitled "Coordination with the Natural Gas Act," links the pricing structure of the NGPA with the provisions of the Natural Gas Act. In Section 601(c), 15 U.S.C. 3431(c), Congress vested the Commission with the authority to ensure that a pipeline's purchased gas costs meet at least two conditions before the Commission allows them to be passed on to the pipeline's customers as "just and reasonable" under Sections 4

106(b), 15 U.S.C. 3312(c), 3313(c), 3315 and 3316(b), was deregulated on January 1, 1985. See Section 121(a), 15 U.S.C. 3331(a).

[3] Incentive categories are: new natural gas and certain Outer Continental Shelf gas (Section 102, 15 U.S.C. 3312); gas from new, onshore production wells (Section 103, 15 U.S.C. 3313); high-cost natural gas (Section 107, 15 U.S.C. 3317); and stripper-well natural gas (Section 108, 15 U.S.C. 3318).

[4] See NGPA Section 104, 15 U.S.C. 3314 (natural gas dedicated to interstate commerce); Section 106, 15 U.S.C. 3316 (gas sold under rollover contracts); and Section 109, 15 U.S.C. 3319 (gas not qualifying for another maximum lawful price).

[5] Ringleb, *Natural Gas Producer Price Regulation Under the NGPA: Regulatory Failure, Alternatives, and Reform*, 20 Houston L. Rev. 709, 711-712 (1983) (footnote omitted). See also Note, *Legislative History of the Natural Gas Policy Act: Title I*, 59 Tex. L. Rev. 101, 116-124 (1980).

and 5 of the Natural Gas Act: (1) that the price was not "excessive due to fraud, abuse, or similar grounds" (Section 601(c)(2), 15 U.S.C. 3431(c)(2)); and (2) that the price was consistent with the Commission's rules regarding incremental pricing under Title II of the NGPA, 15 U.S.C. 3341 *et seq.* (Section 601(c)(2)(B), 15 U.S.C. 3431(c)(2)(B)).

B. The Relevant Facts Of This Case

Beginning in 1978, Transco entered into approximately 35 long-term contracts, some of which contained take-or-pay provisions,[6] to purchase deregulated high cost (Section 107) natural gas from interest-owners in a common pool (the Harper Sand gas pool) in Mississippi (J.S. 2-4; J.S. App. 8a-9a). Until the summer of 1982, Transco purchased all the gas tendered to it from the pool by the various interest owners, regardless of whether it had a contract with the selling interest-owner or not. In the spring of 1982, however, Transco began to experience problems selling its gas to its interstate system-supply customers (J.S. 6; J.S. App. 10a-12a). As a result, in May 1982 Transco announced it would no longer take or purchase gas from the interest owners and producers with whom it did not have contracts (J.S. App. 11a).

Coastal Exploration, Inc., and other non-contract working interest owners, thereupon petitioned the

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[6] A "take-or-pay" provision in a gas contract requires the purchaser to pay for a specified volume of gas that the producer-seller has available for delivery, regardless of whether the purchaser takes the gas or not. Under such a clause the purchaser usually has the right to take in succeeding years the gas paid for but undelivered.

Mississippi State Oil and Gas Board to enforce its Rule 48, a ratable-take rule (J.S. 6-7),[7] by requiring Transco to purchase from each interest-owner in the pool—including those with whom Transco had no contracts—the same percentage of the pool's allowable production as it purchased from every other interest owner. Transco urged the Board instead to reduce the "allowables" (*i.e.*, the maximum permissible production[8]) for the pool to reflect market demand, or, alternatively, to allocate ratably to all producers the volumes Transco was obliged by contract to purchase from certain of the interest owners. The Board rejected these alternatives. Instead, it required Transco to purchase the reservoir's full allowables ratably from all interest-owners (J.S. App. 104a-113a). The Board also required Transco to purchase all such gas —even the gas that it had not contracted to purchase —under non-discriminatory price and take-or-pay conditions (J.S. App. 112a).

C. The Decisions Of The State Courts

The Mississippi State Circuit Court of the First Judicial District of Hinds County affirmed the Board's order (J.S. App. 59a-103a). It found that the order did not violate this Court's decision in *Northern Nat-*

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[7] That rule provides:

> Each person now or hereafter engaged in the business of purchasing oil or gas from owners, operators, or producers shall purchase without discrimination in favor of one owner, operator, or producer against another in the same common source of supply.

[8] In Mississippi, the "allowables" for gas reservoirs are established at the maximum amount of gas a reservoir is capable of producing. See Miss. Code Ann. § 53-1-1 (1972) (reproduced at J.S. App. 128a-129a).

ural Gas Co. v. *State Corporation Commission*, 372 U.S. 84 (1963),[9] or invade the Commission's regulatory authority. In the state court's view, the NGPA had eliminated Commission jurisdiction over wellhead sales of Section 107 gas and other deregulated gas, thereby creating a lacuna the state could fill (J.S. App. 73a-77a).

On further review, the Mississippi Supreme Court reversed the Board's order to the extent that it proscribed differences in wellhead prices, because, in its view, the Mississippi legislature had not authorized the Board to set prices for gas at the wellhead (J.S. App. 48a-55a). However, the Mississippi Supreme Court upheld the Board's order in all other respects. It agreed with the circuit court's view of the effect of the NGPA on *Northern Natural* (J.S. App. 22a-29a). Nor did the court believe that the Board's order violated the Commerce Clause of the United States Constitution. Citing *Cities Service Gas Co.* v. *Peerless Oil & Gas Co.*, 340 U.S. 179 (1950), the court held that increased prices to consumers in other states do not necessarily render a state's regulation unconstitutional.

SUMMARY OF ARGUMENT

1. More than 20 years ago in *Northern Natural Gas Co.* v. *State Corporation Commission*, *supra*, this Court set aside state ratable-take orders similar to the order at issue here on the ground that they affected the ability of the Commission "to regulate comprehensively and effectively the transportation

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[9] In *Northern Natural* this Court held that ratable-take orders of the State of Kansas, like the kind involved in this case, were preempted by the Natural Gas Act. See discussion pp. 17-19, *infra*.

and sale of natural gas, and to achieve the uniformity of regulation which was an objective of the Natural Gas Act." 372 U.S. at 91-92. In this case, the Mississippi courts refused to follow *Northern Natural* on the ground that the NGPA had overturned that decision. Passage of the NGPA, which operates as an overlay upon the provisions of the Natural Gas Act, was not meant to achieve such a result; it simply does not permit the states to assert regulatory authority over wellhead sales in interstate commerce.

The NGPA makes clear that Congress, in removing certain wellhead sales from the Commission's regulatory jurisdiction, intended that they be *de*regulated; it did not intend to permit state regulation sufficient to justify the state Board's ruling here. The state Board's order thus interferes impermissibly with the NGPA, its relationship to the Natural Gas Act, and the nice balance struck in those Acts between regulated and deregulated prices of natural gas.

Additionally, the State, through the Board's order, directly interferes with specific responsibilities delegated by Congress to the Commission under the NGPA/Natural Gas Act scheme. In Section 601 of the NGPA, Congress specifically provided for the Commission's regulation of the passthrough of pipelines' costs of gas purchases to their interstate customers. To this end the Commission is authorized to permit a pipeline to pass through wellhead gas purchase costs if the costs are not "excessive due to fraud, abuse, or similar grounds" (15 U.S.C. 3431(c)(2)) (whether or not they are deregulated prices) and are at levels consistent with the incremental pricing system established under Title II of the NGPA. The Board's order collides with the Commission's duty

under each of these two discrete provisions. The state Board's order interferes with the Commission's responsibility to ensure that Transco's gas purchase costs do not violate the "fraud, abuse, or similar grounds" standard, since the state action will ensure higher rates to interstate customers without any offsetting benefit to them. In addition, the Board's order collides with the aim of the incremental pricing system: to compel pipelines to bid responsibly for deregulated supplies of gas.

In sum, the state Board's order is fundamentally at odds with the federal scheme requiring the Commission to coordinate the NGPA and Natural Gas Act to foster a market in which natural gas can be produced in sufficient quantities at the lowest cost.

2. In any event, the Board's order impermissibly burdens interstate commerce. Through this order, the State has guaranteed a larger share of the interstate market to high-cost Mississippi gas than might otherwise have been secured, and it has done so at the expense of out-of-state customers. This result cannot be justified by the assertion that the State's action is a legitimate conservation measure. The order itself requires gas depletion, and the State has alternative and less intrusive means of checking waste or discriminatory taking through rules aimed not at purchasers but at producers.

This Court's decision in *Cities Service Gas Co.* v. *Peerless Oil & Gas Co.*, 340 U.S. 179 (1950), does not support the ruling of the courts below, because that decision turned on the minimal impact that the very low wellhead prices of gas then prevailing would have on the price of the gas delivered to consumers (340 U.S. at 187). Current wellhead prices are a great deal higher; they constitute more than half of the price paid by today's gas consumers. Accordingly,

the facts upon which *Cities Service Gas Co.* was based have changed so significantly that its rationale would not today support the result reached in 1950.

ARGUMENT

I. THE STATE RATABLE-TAKE RULE AT ISSUE HERE IS INVALID BECAUSE IT IS INCONSISTENT WITH THE COMPREHENSIVE FEDERAL SCHEME OF REGULATION OF INTERSTATE TRANSACTIONS INVOLVING NATURAL GAS

Both state courts below recognized that if there were no NGPA, the Natural Gas Act, as construed by this Court in *Northern Natural*, would stand as clear authority invalidating Rule 48 of the State Oil and Gas Board.[10] The state courts sought, however, to avoid the reach of *Northern Natural* on the ground that in the NGPA "Congress has declared that the first sale of deregulated gas is never made subject to the Natural Gas Act or to FERC's jurisdiction under the act" (J.S. App. 25a). We submit that the courts'

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[10] The Mississippi Supreme Court unequivocally stated (J.S. App. 22a):

> All parties agree that prior to 1978 there existed in the Federal Energy Regulatory Commission (formerly the Federal Power Commission) plenary authority to regulate the sale and transportation of natural gas in interstate commerce. No one questions that prior to 1978 this federal authority within its sphere was more than sufficient to preempt any otherwise lawful state authority. *Northern Natural Gas Co.* v. *State Corporation Commission of Kansas*, 372 U.S. 84, 89-90, 83 S.Ct. 646, 649, 9 L.Ed.2d 601, 606 (1963). Prior to 1978 this state was without authority to enforce Rule 48 requiring ratable taking, and any order such as Order No. 409-82 would have been wholly *ultra vires*.

See also J.S. App. 24a-25a.

view wholly misperceives both the scope and coverage of the NGPA and the present viability of *Northern Natural*. We first demonstrate that Congress did not, when it enacted the NGPA, intend the anomalous result of allowing the state to regulate wellhead transactions that were removed from Commission jurisdiction. We show next that *Northern Natural* has not been rendered obsolete by the enactment of the NGPA and that its teaching bars the state action challenged here.

A. The Presently Operative Federal Scheme Of Natural Gas Regulation Occupies The Entire Field Of Wellhead Transactions And Thus Renders The State Order Invalid

Appellee argues that Congress, when it enacted the NGPA, meant to grant to the states expansive power over wellhead transactions at the same time as it signficantly narrowed Commission regulatory authority over such sales. But this argument attributes to Congress the self-defeating intent " 'to paralyze with one hand what it sought to promote with the other.' " *American Paper Institute, Inc.* v. *American Electric Power Service Corp.*, 461 U.S. 402, 421 (1983) (quoting *Clark* v. *Uebersee Finanz-Korporation, A.G.*, 332 U.S. 480, 489 (1947)).

1. In enacting the NGPA, Congress enlarged the focus of federal regulation under the Natural Gas Act by establishing a comprehensive and uniform national scheme of prices for gas at the wellhead applicable to intrastate as well as interstate sales, thereby ending distortions created by separate state and national regulation.

Under the Natural Gas Act, the Commission, until 1954, had exercised regulatory authority only over

the rates and activities of interstate pipelines, not independent producers. Following this Court's decision in *Phillips Petroleum Co.* v. *Wisconsin*, 347 U.S. 672 (1954), however, the Commission also began to regulate producer (wellhead) sales to interstate pipelines. Producers, like interstate pipelines, were thereafter required to obtain certificates of public convenience and necessity from the Commission to enter into interstate transactions under Section 7 of the Natural Gas Act, 15 U.S.C. 717f, and the Commission was statutorily obligated to insure that such sales were at "just and reasonable" rates under Sections 4 and 5 of the Act, 15 U.S.C. 717c and 717d. As this Court recently noted, in the wake of *Phillips* the problems of regulating the natural gas industry grew steadily, and "it became apparent that the regulatory structure was not working." *Public Service Commission* v. *Mid-Louisiana Gas Co.*, 463 U.S. 319, 330 (1983).

A rapidly increasing demand for natural gas exacerbated the problems inherent in implementing *Phillips*. What emerged was a sharp division between the regulated interstate market and the intrastate markets, which were not subject to Commission regulation under the Natural Gas Act. In the early 1970's, this artificial division solidified, and the nation's gas situation worsened as the prices for gas in the intrastate markets grew substantially higher than prices in the interstate market. This price disparity adversely affected the dedication of gas to the interstate market, resulting in serious shortages of gas available for interstate sale. The NGPA was enacted in large measure to eliminate these problems and to provide for increasing reliance on market forces to control sales of gas at the wellhead. S. Rep. 95-436,

95th Cong., 1st Sess. 7-9, 18-25 (1977); H.R. Rep. 95-496, 95th Cong., 1st Sess. Pt. 4, at 101 (1977); H.R. 8444, 95th Cong., 1st Sess. § 401 (1977) (Findings and Statement of Purposes); S. 2104, 95th Cong., 1st Sess. § 2 (1977) (Findings and Purposes).

To this end, in Title I of the NGPA Congress removed price controls altogether from certain categories of gas, including Section 107 gas, to stimulate supplies at the limit of economic recovery. As Senator Jackson explained in presenting the conference report on the NGPA (124 Cong. Rec. 28633 (1978) (emphasis added)):

> Our objective was to target the revenues a producer can expect to receive from production from a given well. *We wanted to elicit the maximum supply response at a minimum cost to consumers.* For example, the most expensive kinds of wells to drill, those over 15,000 feet in depth, are deregulated * * * [because] * * * they deserve the maximum economic incentive.

Since Congress explicitly exercised its power in Section 121 of the NGPA, 15 U.S.C. 3331,[11] to subject certain wellhead sales to the free play of economic forces, its decision is entitled to preemptive force as against state efforts to regulate the area.

As this Court explained in *Lodge 76, International Association of Machinists* v. *Wisconsin Employment Relations Commission*, 427 U.S. 132, 150-151 (1976) (citations and footnote omitted; brackets in original):

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[11] Section 121, entitled "Elimination of price controls for certain natural gas sales" essentially removed, in three stages, the maximum lawful prices applicable to certain categories of natural gas.

> To sanction state regulation of such economic pressure deemed by the federal Act "desirabl[y] . . . left for the free play of contending economic forces, . . . is not merely [to fill] a gap [by] outlaw[ing] what federal law fails to outlaw; it is denying one party to an economic contest a weapon that Congress meant him to have available." Accordingly, such regulation by the State is impermissible because it " 'stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress.' "

See also *Arkansas Electric Cooperative Corp.* v. *Arkansas Public Service Commission*, 461 U.S. 375, 383-385 (1983).

2. The state order involved here significantly frustrates the free market policies embodied in the NGPA. It would not only require Transco to purchase high-cost Section 107 gas when cheaper gas might be available, but it also would hamper the operation of free market forces by giving the states leverage to control first sales of natural gas.

While the Mississippi Supreme Court declared that the Board's order was invalid to the extent that it explicitly established a price for the gas, this does not eliminate the basic flaw of the order. On the contrary, because of the take-or-pay contract provisions, Transco is faced with a Hobson's choice: its first option is to increase its purchases of high-cost gas from all wells in the common pool to the highest level at which it is contractually required to purchase from any single interest-owner, and make corresponding reductions elsewhere, thereby burdening its interstate customers with high-cost gas when there is already a glut of high priced gas in its interstate market. Transco's other option is no more attrac-

tive: it can reduce the volume of its purchases from the interest-owners with whom it has contracts, and limit its purchases from the other interest-owners in the pool to like percentages, thereby incurring take-or-pay liability for the volumes it fails to take under its contracts and similarly burdening its interstate customers with these added costs.[12] In either event, the order interferes with the market forces that Congress believed should ultimately govern wellhead sales and "indirectly achieves the * * * result" of "state regulation of the prices of interstate wholesales of natural gas" condemned in *Northern Natural*, 372 U.S. at 91 (footnote omitted).

3. To be sure, the NGPA does not, in so many words, bar state control over wellhead sales in interstate commerce. But congressional silence can hardly support the conclusion that Congress intended to allow the states to exercise authority over such transactions.[13] While Congress clearly meant to replace

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[12] Had there been no state order, Transco would have been free to avoid or minimize take-or-pay liability by taking no more than contracted-for amounts of gas from the pool.

[13] This, of course, is not to say that the state has no power to check waste and discrimination in the taking of gas from the ground. Indeed, this Court, in *Northern Natural*, 372 U.S. at 94-95 n.12, recognized the existence of that state authority, noting approvingly "proration and similar orders aimed at producers." Thus, as one commentator has observed, state regulatory orders enforcing ratable production in a field at market-demand levels (*i.e.*, true market-demand proration orders) cannot be manipulated for purposes of economic protectionism and would therefore obviate the problem posed by the Mississippi Board's order, which imposes on an interstate pipeline the obligation to purchase more state gas than it requires. Note, *Natural Gas Regulation and Vested Property Interests: Ratable Taking, Proration Standards and Field-*

blanket Commission authority to set prices for sales of gas at the wellhead with the comprehensive scheme of Title I of the NGPA, see *Mid-Louisiana Gas Co.*, 463 U.S. at 332-336, there is not a shred of evidence that it intended, at the same time, to allow the states to substitute their authority for that of the Commission and to regulate wellhead sales.

On the contrary, it appears the preemption principle that this Court recently reiterated is equally applicable here: "a federal decision to forgo regulation in a given area may imply an authoritative federal determination that the area is best left *un*regulated, and in that event would have as much preemptive force as a decision *to* regulate," *Arkansas Electric Cooperative Corp.*, 461 U.S. at 384 (emphasis in original). This, in other words, is a case where " '[t]he scheme of federal regulation [is] so pervasive as to make reasonable the inference that Congress left no room for the States to supplement it,' because 'the Act of Congress may touch a field in which the federal interest is so dominant that the federal system will be assumed to preclude enforcement of states laws on the subject.' " *Fidelity Federal Savings & Loan Ass'n* v. *De La Cuesta*, 458 U.S. 141, 153 (1982) (quoting *Rice* v. *Santa Fe Elevator Corp.*, 331 U.S. 218, 230 (1947)). The legislative background, pp. 12-13, *supra*, confirms that these principles govern here.

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wide Civil Liability, 62 Tex. L. Rev. 691, 722-723 (1983). See also Sections 503, 505 of the NGPA, 15 U.S.C. 3413, 3415; 124 Cong. Rec. 38366 (1978) (remarks of Rep. Dingell, House manager of the NGPA, explaining that state authority to pro-rate production is unaffected by NGPA). We certainly do not challenge the state's authority to achieve its conservation goals through alternatives that do not interfere with federally-protected interests.

Indeed, when Congress intended to allocate regulatory authority to the states in the NGPA, it clearly knew how to do so. In Section 602(a) of the Act, 15 U.S.C. 3432(a), Congress allowed states to impose price ceilings (less than the NGPA maximum price, but not higher) over first sales of gas, but only if the gas is produced and sold in intrastate commerce. See H.R. Conf. Rep. 95-1752, 95th Cong., 2d Sess. 124-125 (1978).[14] In light of this carefully limited grant of state authority, it is inconceivable that Congress meant, sub silentio, to cede any additional Commerce Clause authority to the states.

B. The State's Regulation Of Transco's Purchasing Practices Directly Conflicts With The Commission's Regulatory Responsibilities Under The NGPA And The Natural Gas Act

Because, as we have shown, Congress enacted Title I of the NGPA to free wellhead sales of natural gas from the very type of utility regulation the state has sought to impose here, that regulation is invalid under traditional preemption principles. But even if Congress's intent to eliminate such regulation were less clear, the state Board's order would be invalid because it conflicts with the Commission's authority, granted to it by Congress under both the NGPA and the Natural Gas Act, to regulate what this Court has described in *Northern Natural* as "the intricate re-

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[14] This Court has explained that under this provision the states are limited to establishing maximum prices for intrastate sales which do not exceed the NGPA maximum lawful price "in accordance with the overall national policy." *Energy Reserves Group, Inc.* v. *Kansas Power & Light Co.*, 459 U.S. 400, 421 (1983); see also *Exxon Corp.* v. *Eagerton*, 462 U.S. 176, 186-187 (1983).

lationship between the purchasers' cost structures and eventual costs to wholesale customers who sell to consumers in other States." 372 U.S. at 92.

In *Northern Natural* this Court set aside orders, quite similar to those at issue here, requiring ratable takes from Kansas wells, on the ground that the "orders necessarily deal with matters which directly affect the ability of the Federal Power Commission [now FERC] to regulate comprehensively and effectively the transportation and sale of natural gas, and to achieve the uniformity of regulation which was an objective of the Natural Gas Act." 372 U.S. at 91-92. As this Court there explained:

> The federal regulatory scheme leaves no room either for direct state regulation of the prices of interstate wholesales of natural gas, or for state regulations which would indirectly achieve the same result * * *.
>
> The danger of interference with the federal regulatory scheme arises because these orders are unmistakably and unambiguously directed at *purchasers* who take gas in Kansas for resale after transportation in interstate commerce. * * * Moreover, any readjustment of purchasing patterns which such orders might require of purchasers who previously took unratably could seriously impair the Federal Commission's authority to regulate the intricate relationship between the purchasers' cost structures and eventual costs to wholesale customers who sell to consumers in other States.

Ibid. (emphasis in original; citation and footnote omitted).

The state order in this case suffers from the very infirmity that invalidated the ratable-take orders in

Northern Natural. Here, as there, the State's order is tantamount to "state regulation of the prices of interstate wholesales of natural gas," 372 U.S. at 91; and here, as there, the state regulation must fall.

While the Mississippi Supreme Court ruled that the state Board may not set the wellhead price because it had not been authorized to do so by the state legislature (J.S. App. 48a-55a), it nonetheless effectively gave the Board that power and more. It did so by upholding state requirements that Transco purchase volumes of deregulated gas in excess of volumes the pipeline had contracted to buy (or might even need), or alternatively subject itself to take-or-pay liabilities. Thus, enforcement of the state rule will affect more than simply the price Transco pays in actually buying the deregulated gas. By controlling Transco's overall gas purchasing practices, the Board's order weakens substantially the effect of any attempt the pipeline otherwise might make to minimize the overall cost of its customers' gas. In this way, the Board's order raises the prices Transco's interstate customers must pay for gas.[15]

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[15] The Mississippi Supreme Court described this effect very clearly when, in referring to Transco's right under Section 601(c) of the NGPA to pass its costs of purchasing gas through to the consumer, that court observed (J.S. App. 37a-38a):

> it is not Transco who experiences a burden, it is the consumer. If higher purchasing prices at the wellhead lead to higher prices to the consumer and a loss of markets, this is simply one inevitable consequence of the free market policies of the era of deregulation * * *.

That court's fundamental error is that under its ruling the "inevitable consequence" of higher consumer prices is not a function of free market policies; rather, the higher prices are the direct result of state regulation. And it is this error which

The state courts focused only on what the Commission could *not* regulate under the NGPA—the wellhead price set by contract between producers and Transco—while ignoring the impact of the Board's order on the pipeline's customers. As the State Supreme Court stated its rationale:

> FERC has no authority to intervene when the pipeline, denied pass through [under Section 601 (c)], seeks to get out of its deal with the producers. Though the price paid at the wellhead may well be FERC-determined excessive as the product of fraud or collusion when pass through is sought, it remains a just and reasonable price *as a matter of law* as between the pipeline and the producer. 15 U.S.C. § 3431(b)(1)(A). Nothing in the pass through provisions of NGPA continues in effect any FERC jurisdiction over wellhead first sales of deregulated natural gas.

J.S. App. 27a (emphasis in original).[16]

Proper analysis of a pipeline's purchasing practices does not, however, focus on the wellhead transaction between the producer and the pipeline; it focuses, as this Court recognized in *Public Service Commission* v. *Mid-Louisiana Gas Co.*, *supra*, on the very different regulatory context of the pipeline's relationship with its downstream customers:

> The NGPA is designed to preserve the Commission's authority under the [Natural Gas Act]

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brings the state into direct conflict with the Commission's regulatory duties.

[16] The lower state court stated the matter more succinctly: "FERC still has no authority or jurisdiction (not even under Section 601(c)) to regulate or control a pipeline's purchase of [Section] 107 gas, or the price the pipeline pays to producers or the pipeline's contract with producers" (J.S. App. 74a).

> to regulate natural gas sales from pipelines to their customers; however, it is designed to supplant the Commission's authority to establish rates for the wholesale market, the market consisting of so-called 'first sales' of natural gas.

463 U.S. at 331. So examined, the state action in this case stands in the way of the Commission effectuating its significant statutory duties.

First, the state order tends to frustrate the Commission's exercise of its statutory authority under Section 601(c)(2) to deny a pipeline pass through of wellhead prices because of "fraud, abuse or similar grounds." [17] This is so because the state has dictated what Transco's wellhead gas purchasing practices should be. Thus, a practice that the Commission, under the statute, might have found to be an "abuse" meriting a denial of pass through if done at the pipeline's own initiative—the purchase of expensive deregulated gas when alternative lower-cost supplies were available—is a required practice by order of

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[17] The Commission has opened inquiries into pipeline purchasing practices under the "fraud, abuse, or similar grounds" standard of Section 601(c)(2) in approximately 16 cases. See, *e.g.*, *Transcontinental Gas Pipeline Corp.*, 23 F.E.R.C. ¶ 61,292 (1983), 26 F.E.R.C. ¶ 61,361 (1984).

The Commission construed the Section 601(c)(2) standard in *Columbia Gas Transmission Corporation*, 26 F.E.R.C. ¶¶ 61,034 and 61,334 (1984), appeal pending *sub nom. Office of the Consumers' Counsel* v. *FERC*, No. 84-1099 (D.C. Cir. filed Mar. 16, 1984). In that case, the Commission explained Section 601(c) and its right of guaranteed pass through as carrying with it "the duty of the pipeline to take reasonable actions to minimize gas costs [to its customer]" and stated that "[t]he statutory limitation on automatic pass through on grounds of fraud or abuse should be interpreted in light of this duty." 26 F.E.R.C. at 61,100.

The Commission further ruled that the term "abuse" was meant to include "circumstances where a pipeline's gas acqui-

the State. In giving the Commission the authority to deny pass through only under the "fraud, abuse or similar grounds" standard, Congress implemented a policy of generally allowing the free market to operate so that pipelines minimize their gas costs, while at the same time market incentives provide increased natural gas production.[18] Since the State's regulation requiring purchases of specific volumes of high-cost gas frustrates the ability of pipelines to minimize gas costs and limits the Commission's authority to monitor pipeline purchasing practices under the "fraud, abuse or similar grounds" standard of Section 601(c)(2), that regulation " 'stands as an obstacle to the accomplishment and execution' " of the statutory purpose. *Lodge 76, International Association of Machinists*, 427 U.S. at 151 (quoting *Hill* v. *Florida*, 325 U.S. 538, 542 (1945)).

Second, the Board's order conflicts with the Commission's related statutory authority under Section 601(c)(2)(B) of the NGPA, 15 U.S.C. 3431(c)(2)(B), to assure that the pipeline's pass through of its gas costs is consistent with rules implementing the

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sition policies and practices evidence a reckless disregard of the pipeline's fundamental duty to provide service at the lowest reasonable cost and such policies have significant, adverse consequences." 26 F.E.R.C. at 61,000.

The Commission also ruled that other traditional remedies are available under the Natural Gas Act to deal with "imprudent" purchasing practices. See 26 F.E.R.C. ¶¶ 61,034 and 61,334 (1984).

[18] Indeed, the Congressional goal of linking pass through to minimization of gas costs is underscored by the "affiliated entities limitation" of Section 601(b)(1)(E), which, as this Court noted in *Mid-Louisiana Gas Co.*, 463 U.S. at 340, links the "justness and reasonableness" of the price a pipeline pays for gas from its affiliate to comparable first sales between persons *not* affiliated with the pipeline.

incremental pricing provisions of Title II of the NGPA.[19]

Congress has emphasized that "recovery [under Section 601(c)] must be consistent with incremental pricing," H.R. Conf. Rep. 95-1752, 95th Cong., 2d Sess. 124 (1978). Incremental pricing was designed by Congress to eliminate any incentive for pipelines to bid excessively high prices for deregulated supplies, relying on the relatively low price of gas remaining under control to moderate the prices charged its customers.[20] As Representative Dingell, House manager of the NGPA, explained:

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[19] Title II directs the Commission "to establish, monitor, and enforce a mandatory pipeline accounting and billing system that will result in a surcharge on sales of gas used [for certain industrial uses]. The amount of the surcharge is to be determined by the difference between part of the costs of acquiring certain categories of high cost gas and the price of an appropriate alternative fuel" (Haase, *The Federal Role in Implementing the Natural Gas Policy Act of 1978*, 16 Houston L. Rev. 1067, 1075 (1979)).

[20] Thus, the NGPA provides that deregulation of high-cost gas cannot take effect until the effective date of the first incremental pricing rule. See Section 121(b) of the NGPA, 15 U.S.C. 3331(b). *Consumer Energy Council of America* v. *FERC*, 673 F.2d 425, 434-437 (D.C. Cir. 1982).

In September 1979, the Commission adopted the Phase I Rule required by the statute, applying incremental pricing to industrial boiler fuel users. See *FERC Order No. 49*, 8 F.E.R.C. ¶ 61,333 (1979). However, its Phase II Rule, making incremental pricing applicable to all industrial users not specifically exempted by statute, was rejected by Congress's use of the legislative veto. That Congressional veto, however, was found unconstitutional. *Consumer Energy Council of America* v. *FERC*, *supra*. The Commission's Phase I Rule remains in effect. See 18 C.F.R. Pt. 282. Under that Rule, the Commission has allowed the states to implement their own substitute

> Incremental pricing * * * focus[es] initial price increases on the pipelines' most price sensitive customers: historically underpriced industrial users. By allowing the delivered price of these customers' gas to rise to the level of alternative fuels, incremental pricing limits the ability of the pipeline to pass through high prices for new gas. *Constrained by the limits this places upon the passthrough of increased costs of gas, pipelines will be forced to bid responsibly for deregulated supplies of gas or face a loss of customers and an associated reduction in throughput volumes and profits.*

124 Cong. Rec. 38361 (1978) (emphasis added). Accordingly, an integral part of the incremental pricing system established by Title II of the NGPA is its reliance on market forces to control the wellhead price of high cost gas. The state ratable take rule substitutes state regulation for the free market necessary to make the incremental pricing provisions operate as Congress intended.

In Section 601(a)(1)(B) of the NGPA, 15 U.S.C. 3431(a)(1)(B), Congress provided that the Commission's jurisdiction under the Natural Gas Act should not apply "solely by reason of any first sale" of deregulated gas. Far from creating a regulatory gap to be filled in at the State's option, it is clear that Section 601(a) is part of a carefully limited restructuring of the Commission's authority in a new, integrated regulatory system. The manifest purpose

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incremental pricing plans, subject to Commission approval. See 18 C.F.R. 282.208. This Commission action is the subject of challenge in the District of Columbia Circuit. See *American Paper Institute* v. *FERC*, No. 81-1071 (argued Jan. 27, 1982).

of Section 601(a) was to exclude the first sale by independent procedures of certain gas, like the deregulated Section 107 gas involved here, from the certification and tariff (wellhead pricing) authority of the Commission under the Natural Gas Act that followed the decision in *Phillips Petroleum Co.* v. *Wisconsin*, *supra* (see pp. 11-13, *supra*).[21] There is not the slightest hint that Section 601(a) was intended to go further and abrogate the Commission's traditional Natural Gas Act responsibility to regulate the relationship between a pipeline *and its system customers*, the responsibility implicated here and in this

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[21] The legislative history of Title I of the NGPA makes entirely clear that the major focus of congressional concern was on the regulatory difficulties arising out of the effort to implement the decision in the *Phillips* case. See, *e.g.*, S. Rep. 95-436, 95th Cong., 1st Sess. 7-9 (1977); H.R. Rep. 95-496, 95th Cong., 1st Sess. Pt. 4, at 89-90 (1977); 123 Cong. Rec. 2141-2142 (1977) (remarks of Sen. McClure); *id.* at 19964-19965 (remarks of Rep. Kemp), see also H.R. 8444, 95th Cong., 1st Sess. § 401 (1977) (Findings and Purposes). Indeed, the House Bill included a section that would have amended the definition of "natural-gas company" in Section 2(6) of the Natural Gas Act, 15 U.S.C. 717a(6), to exclude any person making sales under certain enumerated sections of the bill. The amendment would effectively have overruled *Phillips* by excluding certain producer sales from Commission regulation under the Natural Gas Act. H.R. 8444, *supra*, § 416. See H.R. Rep. 95-496, *supra*, at 109. The Conference Report explains that the NGPA "limits the jurisdiction of the Commission under the Natural Gas Act in a manner similar to the House-passed bill." H.R. Conf. Rep. 95-1752, *supra*, at 123. Accordingly, Section 601(a)(1)(D), 15 U.S.C. 3431(a)(1)(D), provides that if a person's sales of certain gas are excluded from the Commission's Natural Gas Act jurisdiction by virtue of Section 601(a)(1)(A)-(C), that person shall not be included within the definition of "natural-gas company" in the Natural Gas Act.

Court's decision in *Northern Natural.* See *Mid-Louisiana Gas Co.*; *Exxon Corp.* v. *Eagerton*, 462 U.S. at 184-186; *Columbia Gas Development Corp.* v. *FERC*, 651 F.2d 1146, 1149-1150 (5th Cir. 1981).

II. THE BOARD'S ORDER IMPERMISSIBLY INTERFERES WITH INTERSTATE COMMERCE

A. Aside from preemption concerns, the Board's order impermissibly burdens interstate commerce since its effect is to secure a larger share of the interstate gas market for high-cost gas produced in Mississippi and thereby to increase revenues to Mississippi producers at the expense of out-of-state customers. This sort of economic protectionism is flatly prohibited under the Commerce Clause.

More than sixty years ago this Court held that "[n]atural gas is a lawful article of commerce and its transmission from one State to another for sale and consumption in the latter is interstate commerce." *Pennsylvania* v. *West Virginia*, 262 U.S. 553, 596 (1923). Accordingly, "[a] state law * * * of the State where the gas is produced * * *, which by its necessary operation prevents, obstructs or burdens such transmission is a regulation of interstate commerce,—a prohibited interference." *Id.* at 596-597 (citing cases); see also, *Arkansas Electric Cooperative Corp.* v. *Arkansas Public Service Commission*, 461 U.S. 375, 389-395 (1983); *Exxon* v. *Eagerton*, 462 U.S. at 184. Since, as the Mississippi Supreme Court acknowledged, the Board's order will result in higher gas prices for consumers of gas in other states (J.S. App. 37a-38a), the order is tantamount to the type of economic protectionism that has uniformly been outlawed as an impermissible burden on interstate commerce. See *Arkansas Louisiana Gas Co.* v. *Hall*, 453 U.S. 571, 580-582 (1981);

Maryland v. *Louisiana*, 451 U.S. 725, 753-760 (1981); *City of Philadelphia* v. *New Jersey*, 437 U.S. 617 (1978).[22]

Nor does Mississippi's characterization of its rule as a conservation measure excuse it from the operation of settled Commerce Clause principles.[23] Whether a particular state action constitutes an undue burden on the interstate production and transmission of natural gas is measured by the test enunciated in *Pike* v. *Bruce Church, Inc.*, 397 U.S. 137, 142 (1980) (citation omitted):

> Where the statute regulates even-handedly to effectuate a legitimate local public interest, and its effects on interstate commerce are only incidental, it will be upheld unless the burden imposed on such commerce is clearly excessive in relation to the putative local benefits. * * * If a legitimate local purpose is found, then the question becomes one of degree. And the extent of the burden that will be tolerated will of course depend on the nature of the local interest involved, and on whether it could be promoted as well with a lesser impact on interstate activities.

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[22] In addition, the state Board's ratable-take orders obstructs interstate commerce by placing upon purchasers of gas in interstate commerce—*e.g.*, pipelines like Transco—the burden of performing the complex task of balancing the output of the natural gas wells within the State. See *Northern Natural*, 372 U.S. at 92, 98. Although the present case applies the state ratable-take order only to Transco's purchases from the Harper Sand Gas Pool (J.S. App. 57a-58a), the State rule would equally require ratable taking from all wells producing gas from any other pool within the State.

[23] The accuracy of that characterization is at best dubious, since the net effect of the order is to penalize Transco if it fails to take the full production of all the wells in the pool, regardless of its market for that production. See pp. 6, 14-15, *supra*.

See also *Arkansas Electric Cooperative Corp.* v. *Arkansas Public Service Commission*, 461 U.S. 375, 393-395 (1983). Application of this rule establishes the constitutional error of the state order in this case. The State of Mississippi is not without an alternative means of checking waste or discriminatory taking of gas through proration and similar orders directed at producers. See n.13, *supra*. Since means clearly exist by which the State can protect local interests with a lesser impact on interstate activities, the burden imposed by the state Board's order cannot be justified. *Pike* v. *Bruce Church, Inc.*, *supra*.

B. This Court's decision in *Cities Service Gas Co.* v. *Peerless Oil & Gas Co.*, 340 U.S. 179 (1950), upon which the courts below relied, does not require a contrary result. In that case, the Court upheld an Oklahoma regulation imposing a minimum wellhead price on all gas taken from wells within the state. The Court rejected a Commerce Clause attack on the regulation on the ground that the state regulation represented a reasonable effort to prevent economic and physical waste of natural gas. In finding that this local interest outweighed the national interest, this Court noted that the wellhead price of gas (then 3.6 to 5 cents per Mcf) was "but a fraction of the price paid by domestic consumers at the burner-tip, so that the field price as herein set may have little or no effect on the domestic delivered price" (340 U.S. at 187). The average price for gas at the wellhead has risen to $2.59 per Mcf; that price represents more than 50 percent of the current price of gas at burner-tip.[24] Accordingly, the present field price of gas has

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[24] In 1983 the wellhead price averaged $2.59 while the delivered price to consumers was $4.82. 1 Energy Information Administration, *Natural Gas Annual 1983*, at 6.

a direct and controlling impact on ultimate consumption of gas, and the considerations that supported the holding in *Cities Service Gas Co.* v. *Peerless Oil & Gas Co.*, *supra*, obviously no longer obtain. See *FPC* v. *Corporation Commission*, 362 F. Supp. 522, 535 (W.D. Okla. 1973), aff'd, 415 U.S. 961 (1974).[25]

CONCLUSION

The judgment of the Supreme Court of Mississippi should be reversed.

Respectfully submitted.

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[25] There was, moreover, no contention in *Cities Service Gas Co.* that the state order was inconsistent with the Natural Gas Act, and this Court made no findings in that regard. See 340 U.S. at 180-182; *Northern Natural*, 372 U.S. at 91 n.9.

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